

# *Tackling* SECTION 8 REFORM

MORE THAN YEARS AGO, THE FEDERAL GOVERNMENT CREATED

What has become the largest rental housing subsidy program in the nation's history: Section 8. Beginning in the mid-1970s, an effort to spur the construction of affordable housing and encourage private owners to come into the program, the federal government offered high rental subsidies and entered into 20-year contracts with owners that called for automatic annual rent adjustments.

Now, more than 20 years later, subsidies on some properties have escalated to far exceed rents for comparable apartments on the private market. At the same time, contracts have begun to expire, threatening the continued availability of decent, safe and affordable housing for tens of thousands of low income families.

Congress could not agree at first on a long-term solution to the problem. If rents were simply cut, the danger was that owners would default on their FHA mortgages. That, in turn, would hit the government with multimillion-dollar claims to the FHA insurance funds.

Then, in 1997, after years of debate and experimentation, Congress passed the Multifamily Assisted Housing Reform and Affordability Act, which created the Office of Multifamily Housing Assistance Restructuring (OMHAR) and implemented Mark-to-Market, an innovative, market-oriented program designed to reduce long-term Section 8 costs while preserving much-needed affordable housing. In August testimony before the Senate Banking, Housing and Urban Affairs Committee's Subcommittee on Housing and Transportation, OMHAR's director, Ira Peppercorn, outlined

his office's mandate very succinctly. He said: "The intent was to create an organization within HUD that could be market-driven and rely upon innovative federal, state and local partnerships, but which would have a strong oversight role and some degree of separation. This organization would work

**Ira Peppercorn,**

**director of the**

**Office of Multifamily  
Housing Assistance**

**Restructuring,**

**is leading the effort**

**to put HUD's**

**troubled Section 8**

**program back on**

**more solid ground.**

with its partners to begin the difficult Process of lowering rent subsidies to market rents for thousands of projects, restructuring debt and initiating the physical rehabilitation and repair of properties suffering from years of neglect. It would rely on market standards for establishing new rents, expense levels and rehabilitation needs. It was also Congress' decision that once the organization's mission was accomplished, it would sunset."

To give an indication of the size of the problem, Peppercorn told the Senate that "the new budget authority required annually to renew expiring project-based subsidy contracts would increase from the \$1.2 billion it cost in fiscal year 1997 to almost \$7.4 billion by fiscal year 2006."

'Enacting the legislation that

created OMHAR, however, was just the starting line. To get to the finish line, OMHAR would have to balance the varying interests of owners, lenders and residents, while recognizing, and allowing for, differing social, economic and political goals," Peppercorn said.

Recently, *Mortgage Banking* had a chance to sit down with OMHAR's Peppercorn to talk about the progress that's been made since the Mark-to-Market program began.

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**Q:** *What would you like to tell mortgage bankers about the current status of the Mark-to-Market program and what opportunities there are out there for them?*

**A:** Mark-to-Market is, in its essence, changing what assisted housing looks like and [is] doing that by putting it on a much more market-oriented footing.

Whereas in the past, rents were set by the federal government at what are generally known as FMRs (fair-market rents), we're moving to a different way of understanding markets, which is the way the private sector does it.

When you buy a house, when you rent an apartment, when you buy an apartment complex, what do you look at? You look at what other things in a comparable sell for or rent for. How do they compare? What kind of amenities do they have? What kind of services are near the units? And when you drill down to that kind of level you begin to understand that markets are built from the bottom up, that what's absolutely essential is understanding each market in which you operate and how it affects the property. That's the first fundamental principle of Mark-to-Market---[it] is, in fact, the market.

The second principle is a humility on the part of the fed-

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eral government in that we understand that not only is it not our place to specifically say what rents should be in particular marketplaces, but there are folks who are better at doing it than we are-and that includes not only state and local housing finance agencies and their private-sector counterparts. It also includes people from the appraisal industry who go out every single day and understand the markets. It includes people from the construction industry who know the needs of the properties, and, of course, it includes the tenants as part of the picture.

So you start with an understanding that the way you

need to look at a market changes, and then you come to a deeper understanding that how you see the market changes as well, and those are the fundamental principles behind the second part, the market part.

The first part, the Mark-to-Market part, involves a transition that, in many cases, was the initial impetus for the creation of this law. Rents being paid by the federal government, in many instances, are above the market. In some places, significantly so. If something happened in the future and Section 8 were to go away, what would happen to those properties, to the owners involved in those properties, to the tenants living in those properties? And the answer is that, unless you can bring those to market, mark them to market, you have potential instability in the assisted-housing sector.

So what has to be done? Well, it would not be fair just to say to an owner who has operated in good faith for a long time, "We're cutting the rents, thank you very much," without doing any kind of analysis about whether the property could survive, whether the tenants would be affected, whether the condition of the properties themselves would be impacted. So what we are doing is, in return for asking for a rent reduction, we actually reduce the mortgage. We convert part of the first mortgage into a second mortgage that's payable only out of profits, and, in addition, we are working hand-in-hand with FHA to see if we can lengthen the commitment to a longer Section 8 period for properties so that there can be greater stability.

In essence, what we're seeing, then, is two pieces. One is a change of what the market is, and the other is a pledge to be absolutely fair-when we bring down the rents, making sure that everyone understands that there is a commensurate reduction in the mortgage and conversion to a second mortgage. That's essentially what we're doing.

**Q:** *I read your testimony, and some of the news reports referenced an impatience to see some deals get done. Have you educated the constituency that appears to be impatient as to what it takes to do it the right way?*

**A:** Well, first of all, we have already assigned more than 500 assets into the process. So the process has begun. Moreover, We have signed up 36 state and local housing finance agencies and three private and nonprofit entities working in an additional nine states. So when you look at the track record of what we've done, we've got tremendous coverage around the country. The fact is, we did not start receiving assets in any number until springtime. So our turnaround time has been exceptional.

Once the assets are assigned, there is a process that everyone has to go through. An owner knows, for instance, that he or she has to communicate with [his or her] limited partners about any transaction. Tenants, by law and by our mission, need to be brought into the process to have a voice. The appraisals need to be done. The construction estimates need to be done. The underwriting needs to be done.

All of this needs to be done right. You do not go out-unless you're in an extraordinarily hot market like San Francisco-you do not go out and say, "I'm going to buy a

house today. Here's my checkbook." You go through a process where you say, "How much money do I have to put down? What neighborhood do I want to live [in]? What kind of conditions am I willing to accept on the property?" You need to work hand-in-hand with a mortgage banker, with a Realtor, perhaps with a builder, and you need to make sure that the process is done well and thoroughly--because this is going to be yours for the long term.

**Q:** *You're talking in terms of the owner?*

**A:** I'm using an analogy here for a single-family home purchase. What would you do if you were buying a house? What I'm trying to say is that we have to approach things as thoroughly and as systematically as we would if it were our own. I mean, these are properties that we, as taxpayers, are assisting, that owners have a vested interest in, as do tenants, as do communities. When you are dealing with some-thing of this magnitude-magnitude both financially and magnitude in human terms--you have to be thorough about it. If you look at some of the mistakes that have been made in the past, what you see is that people felt too much pressure to get something done too quickly and were not thorough enough in the process.

Now, all of this needs to be balanced out with the fact that you have a Section 8 clock ticking, and so our mission has been to be thorough but reasonable, market-oriented and clear, understanding that the better job that you do on the front end, the less risk you have on the back end.

**Q:** *Have you found that members of Congress have been receptive to that approach?*

**A:** We presented our testimony, as did the mortgage bankers, to the Senate Banking Committee, and we presented testimony that explained exactly what we've been doing. We've also had conversations with the GAO [Government Accounting Office] [and] numerous conversations with HUD's inspector general, and when you listen to what the GAO and the inspector general have to say, what they say, uniformly...is "build the system and build the system right." Make sure that the work is done properly; make sure that there are consistent standards across the country so that there cannot be accusations of favoritism; make sure that you're market-oriented. We presented a very effective case to the United States Senate, and we received enormously positive feedback from both the Republicans and the Democrats after our hearing.

**Q:** *Let's get to the point of what mortgage bankers can do. Can you tell me what some of the things are that you are looking to the mortgage-banking community for?*

**A:** Mortgage bankers are crucial to the process, because all of these properties have mortgages. If they didn't, then we wouldn't be here with them. So the question is, What do mortgage bankers do? And what mortgage bankers do so effectively--and not just in this sector, in the multifamily sector, but in the single-family sector as well--[is that] mortgage bankers bring capital to the table. Mortgage bankers bring a tremendous skill set of how to use the capital, and are very active participants in their communities. You see mortgage bankers on economic development boards, cham-

bers of commerce and organizations that do industry recruiting. You see them [involved with] organizations that deal with homeownership, because when capital and housing and capital and development come together, that's where you see mortgage bankers.

These properties were done with FHA insurance. Some may stay with FHA insurance. Some may go conventional. Clearly, if they go conventional, there is a tremendous opportunity for mortgage bankers--but even if they stay with FHA, there is an opportunity as well. In many states, there is no public HFA. Financing will absolutely be needed, and there are states where there are public HFAs and some-

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times the refinancing will be done in a very similar manner to the first financing, which could very easily keep a mortgage banker who originally participated in the transaction, and sometimes it might not. The bottom line is that there are opportunities for mortgage bankers to participate with us in virtually every step of the process.

When we have been shaping the program, we've asked for input from around the country. What works? What doesn't work? What do we need to do? How do we do this effectively? Uniformly, mortgage bankers, both in the community and the [MBA] staff here in Washington, have been active participants. They always have a seat at the table with us, and they are always professional and have excellent input.

**Q:** *What have you learned from the Section 8 experience about how not to set policy in the area of a government role for housing?*

**A:** What we've learned is that Section 8 provides an extremely important service in that there are people around the country who do not have enough money to be able to afford to live. So what Section 8 does is it allows them to pay a percentage of their income, and that percentage is a contribution toward the payment made by the federal government. So we have to start from the premise that Section 8 provides a very valuable service to a lot of people around the country.

What we're looking to do is stabilize these properties for the long term, and one of the things that we've learned--and it is not just Section 8--is that the closer you can come to the market, which is what mortgage bankers in the private sector have to do every single day, the better chance you have of being strong and stable for the long term. And so one of the answers to your question is, if we can bring

the principle of a market orientation to Section 8, and keep Section 8 strong, we have a chance to both keep people in their homes and keep the owners with their properties, and keep all of that stable for the long term.

**Q:** *If you were handicapping the prospects of being able to do that, what would you say?*

**A:** I would not have taken this job if I didn't think we had an excellent shot at doing it.

**Q:** *What have been your biggest challenges so far in achieving the goals Congress set out for you?*

**A:** Many of the challenges have been educational ones that you have to lay out for people when you are literally rebuilding a national system that involves thousands of units, billions of dollars of properties, owners who have operated for the long term and tenants who live in them.

A lot of our challenge has been to educate people about exactly what it's going to take to meet this challenge', that to be thorough and prudent you have to make sure people understand the markets. You have to make sure that all of

the parties at the table have a voice. You've got to make sure that people are treated fairly and that the system is set up right on the front end. Once we started to communicate that, the message back has been loud and strong: "Keep on going. You are on the right track."

**Q:** *Have you found a lot of initial skepticism has been built on what HUD used to be or HUD's past track record and the flaws in that-have you been fighting against some of that?*

**A:** Secretary [Andrew] Cuomo has really focused a lot of attention on the management of HUD to rebuild credibility. We understand that a lot of what we're dealing with is old image. But image is not necessarily reality, and that in order to accomplish this mission, we have to work—and will work—in partnership with the department because, in the end, these are properties insured by FHA and [they] will be returned to the FHA portfolio. So we're working with the Department closely, and we're working with partners around the country to stabilize this segment of the

*Following are excerpts of Peppercorn's testimony before the Senate Banking, Housing and Urban Affairs Committee's Subcommittee on Housing and Transportation, August 5, 1999.*

**W**HEN YOU TALK ABOUT BRINGING rents down to market, you are talking about changing, fundamentally changing, a system. You are talking about taking money away from people who have run the projects. You're talking about reassessing the system. You're talking about bringing tenants in. You're talking about making sure it's fair to the lenders.

It's actually a very complex system...that involves a whole array of interests and challenges. And what we have been charged to do is to find that channel through the challenge, through building consensus, through listening to people and through moving the program forward.

One of the things that you'll note, and that the GAO has noted, is that we have gone over and above the congressional mandate in reaching out to the groups and in listening. We did that not only because of all the multitude of interests, but because we needed to team how to do it right.

The approach that we have taken is to build the foundation. We don't just open the

doors and give away the federal taxpayers' pocketbook. We have to reach out to the community. We have to set the procedures. We have to staff people. We have to work with the PAEs [participating administrative entities], which we have wanted to do—work on a contract, set the oversight and train.

In fact, when the GAO looked at us and evaluated the process, with all of the comments about how prescriptive we're being, what they said is that it is going to be important for us to establish procedures—vitally important to protect the public interest. And they said specifically, to our credit, we are focusing on developing oversight procedures prior to the program's implementation.

What we did is, we actually have gone over and above the call of duty in reaching out to the PAEs around the country in bringing them in. And I'd like, Senator, to read you a quote about the program and how it's worked, because you've heard the criticism this morning.

When we worked week after week. collectively, with the HFA on both [the] program operating guide, which, you've seen, and the contract, this was stated about the process:

"Never before has the federal government reached agreement with so many states on so complex an issue in such a short period of time. This unprecedented success is a

tribute to the patience, goodwill and the hard work of the HUD staff and the representatives of the states in intensive negotiations during this very short time."

The person who made that statement was my colleague, John McEvoy.

In closing, I've tried to show that we are navigating through a sea of tremendous challenge. We have built a very good consensus-oriented program. We have gone over and above the call of duty in responding to the HFA concerns, and I am a former member and believe—strongly believe—in that mission. But we have to protect the public trust, both in terms of how we operate and the guidance.

If you listen to the other side of the table, it sounds like it's all gloom and doom and prescription and we're terrible and behind.

My dad used to read me a story. It's about a chicken who was hit on the head with an acorn—Chicken Little. And he saw this as a symbol that the sky was failing and they had to go tell the king.

Senator, the sky is not falling. We are making marvelous progress. We are trying to carve a narrow course between protecting the public interest and creating a good, flexible, fair and—most importantly, as the statute requires—cost-effective system for the American taxpayers.

market, return it to the portfolio, and have it be stable for the long term.

**Q:** *I've read some news articles that indicated the HFAs [housing finance agencies] have not been 100 percent in line with the thinking from the beginning. Has that been one of the challenges for you?*

**A:** Well, if you look at the numbers, the numbers don't bear that out. When you look at the fact that 36 state and locals have signed up already and more are going to be online within the next two weeks, what that tells us is that when each HFA makes his or her own individual decision, the decision, in the vast majority, has been to enter the program.

We also opened our process, so that they had significant input in the design of the operating system that's going to guide us. Sometimes here in Washington we get accustomed to hearing a lot of rhetoric. I spent a decade of my life in Indiana, in the Midwest, where what's important is how you do your job and how you relate to people—and when you look at [the question of] have we done what we said we were going to do and are the HFAs coming in partnership with us, the answer is a resounding yes.

**Q:** *How dire is the situation in terms of a lack of affordable housing stock in this country?*

**A:** It's getting worse. The irony about a strong economy is that a strong economy helps a lot of folks, but a strong economy also has side effects. One of those side effects is that when markets grow, and grow rapidly, people start getting priced out of the market. First, they get priced out of the homeownership market, and then, as is the case in a number of communities around the country, they start getting priced out of the rental market.

Moreover, owners face a decision when markets are hot as to whether or not they want to stay in the affordable-housing market. Most of them do, and a lot of it has to do with the fact that this is a business that they know where they've performed for a long time and that's been good to them. But there's no question about it that, as a nation, we need to do more to provide affordable housing opportunities for all the people that live here.

**Q:** *I imagine you've had a chance to tour a lot of these properties. What strikes you as the overwhelming condition of this housing stock?*

**A:** Most of the stock is in good condition. In fact, HUD's Real Estate Assessment Center has done an analysis of a lot of the properties, and they've said that better than 80 percent are in good condition. What you see, though, is that it will often vary city to city, and that in some areas virtually everything is good and in some areas a number of properties are in trouble.

One of the advantages of what we're doing is that we have the opportunity—even when a property is in difficult physical condition—to work with the owner and the community to improve it. So in addition to the market-oriented check that we do, we're also doing a thorough physical-condition analysis, and if it's proven that the apartments need repair, we've got the capability of dealing with that, and, in a lot of ways, that's part of what will cause some of the

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money to go into the second mortgage. So we will put our money where our mouth is and say we are willing to work with the owner to improve the-property for the long term.

**Q:** *So your office would dictate, then, that a certain amount go toward rehabilitation?*

**A:** It's actually not our office. Let me go through how it would be done. Again, the emphasis here is really on the local level. The state or local housing finance authorities or private partners we're working with, also known as participating administrative entities, or PAEs, do the work. They will go out [and] have a comp study done. They will look at neighboring properties and see what they're renting for, and then they will do an analysis of the physical condition. They are the ones who do that assessment and say, "This property needs work in this area," and they and the owner work together closely to come up with a plan of action that is very much a part of what the financing will look like for the future.

**Q:** *Could you tell a bit about your background and what you bring from that background that helps you do this job?*

**A:** I have both public- and private-sector experience in my background.

For seven years, I ran the state HFA in Indiana, and I was the senior housing adviser to Governor Evan Bayh and Governor Frank O'Bannon. So I understand the way HFAs work and think, how they operate, what they do enormously well and how entrepreneurial you can be, even in the public sector.

I also have experience in the private sector. Early in my career, I worked in venture capital and, most recently, I was with G.E. Capital, where I worked in their commercial real estate and finance area. So I know the way the private sector looks at multifamily properties.

What I bring [to the job] is that balance that understands how this is done in both the public and private sectors, and a track record of both strong financial commitments and a deep and abiding dedication to making sure that people have good places to live.

**Q:** *Has that opened a lot of doors in trying to launch this program?*

**A:** It makes it clear to people that I can talk their language. When tenants ask me, "Well, what do you know?" [I can tell them] I grew up in an apartment in a working-class area. I know what it's like. When the private sector says, "What do you know about multifamily finance?" I can say I've done it. When the HFAs say, "Well, do you know how

an HFA works?" [I can tell them] I've sat in their seat, plus I was also the NO. 2 at FHA, so I know the way FHA works. So [my] background really brings together all of the different pieces.

We've also tried to have a style of operating that's very open. The GAO, in fact, commented on that last year, that we bring people in and listen. What's always important is that you step back and you listen to people, and you ask whether or not you're doing the right thing and you ask how it can be done better, and you try to get at what their concerns and fears and hopes are. It is an active listening process that goes on all throughout the organization.

**Q:** *If you were writing on a clean slate, a whole new federal low-income housing program, what would be the main component of it and what would HUD's role be?*

**A:** One of the main things that we would have is enough resources to really get the job done, and I don't think it would consist of any one particular service or program. You have components that serve well now. You have the low-income housing tax credit. You have bonds. You

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have mortgage financing. You have FHA insurance. You have the secondary markets. You have Realtors and bankers and brokers. So if I were to build a system, the first thing I would try to do is not build all of the pieces, but let the market work where the market knows the most and then look at where there are holes and gaps and how they can best be filled.

**Q:** *For a while there, there was discussion as to whether there should be a HUD. What do you think? How would you respond to that?*

**A:** You've got to look at why those questions are being asked. Are those questions being asked because people have true, real criticisms of the Department, and have those criticisms been listened to? And I think the answer is, yes. There certainly was an element of validity in it, which is why the Department has been working so hard on the management side.

On the other hand, is that all that's behind the criticism? Because you don't just hear criticism of housing. You hear criticism of people without a lot of means. And so when the criticism pushes us in the direction of change, of being market driven, of being results oriented, then we welcome the criticism. When the criticism is, in its essence, an attack on the very constituency that we are dedicated to serving, then we'll fight.

**Q:** *As you've gathered experience from the demonstration program, what's your sense of how many of the current*

*owners will opt to sell once the permanent restructuring is completed?*

**A:** The issue of selling is complicated. There's no one factor. There are some owners who want to stay in and want to stay in for the long term; there are other owners who want to get out, and will; and then there are some owners who want to get out, but face a tax burden, and that's a problem.

We have worked closely with the IRS so that in this program owners get favorable tax treatment. An owner's decision to stay or leave has to do with so many different factors, that it really comes down to a very private, often very personal, business decision. [It is] our job to make our part of the process as efficient as possible and as reasonable as possible so that those who want to stay in can.

**Q:** *Did the amount of the rental overpayment in Section 8 housing and how widespread the problem was--like how many buildings, how many cities--shock you when you first became director of OMHAR? Or did you genuinely understand how widespread the problem was?*

**A:** No, we knew. The problem had been studied enough, so we understood the scope of the problem. What we needed to know better was the particulars. Where? What cities? How many? How much? Those were the questions that we really needed to address and that we are addressing today.

We also understand that markets change and that as markets have improved, the problem of the above-market [rent subsidy] properties has become somewhat lessened. The problem of the below-market properties has become worse, and if the market shifted tomorrow, those ratios could shift again. So one of the things that we certainly are learning is that markets move and that we need to be nimble enough to be moving with them.

I think when you look at the job we have to do, we are balancing a number of competing objectives. We have to balance the Section 8 savings with the write-downs to the FHA fund. We have to balance interests of owners with the needs of the tenants. We have to balance a federal system with the need for innovation at the local level. We've got to balance the business acumen of the mortgage bankers with the other skills that the HFAs bring to the table. We have to balance flexibility with consistency. So, as we have approached the job, we have seen that this is a task where you are swimming through some very narrow channels, trying to listen to people along the way, but [also] trying to balance numerous competing, multiple, difficult objectives. And everybody here is dedicated to doing that, but it's a job that all of us--and when I say "us," I mean broader than the staff here; I mean everyone in the community--believe is an enormous challenge.

**Q:** *It sounds Herculean. Are you still pretty optimistic?*

**A:** I am, actually.

**Q:** *Are you an optimistic person?*

**A:** I'm actually a realist. I'm somebody that looks at things and tries to balance things out. I'm neither an optimist nor a pessimist by nature, and I think we've looked at it realistically. And we've got great people. **MB**